

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Cunneen Analyst: Jeani Brent Bill Number: AB 68

Related Bills: See Legislative History Telephone: 845-3410 Introduced Date: 12/07/1998

Attorney: Doug Bramhall

Sponsor:

SUBJECT: Research Expenses Credit/Increase Credit Percentage/Decrease Minimum Base Percentage

SUMMARY

Under the Personal Income Tax Law and the Bank and Corporation Tax Law, this bill would increase the state credit for "qualified research expenses" from 11% to 15% and would decrease the minimum threshold for the taxpayer's base amount in computing the research expenses credit from not less than 50% to not less than 20% of the taxpayer's current year qualified research expenditures.

EFFECTIVE DATE

This bill would take effect immediately as a tax levy and would apply to taxable or income years beginning on or after January 1, 1999.

LEGISLATIVE HISTORY

AB 2798 (Stats. 1998, Ch. 323); AB 1042 (Stats. 1997, Ch. 613), SB 455 (Stats. 1997, Ch. 611), AB 1067, AB 1499 (1997); AB 3408 (1996), SB 38 (Stats. 1996, Ch. 954); AB 365, AB 397, AB 917, SB 681 (1995); AB 2407 (Stats. 1994, Ch. 949); AB 1824, AB 1893, AB 1911 (1993), SB 671 (Stats. 1993, Ch. 881); SB 1853, AB 2508 (1992); AB 274 (Stats. 1990, Ch. 452); AB 802 (Stats. 1989, Ch. 1352); AB 2130 (Stats. 1988, Ch. 11); AB 53 (Stats. 1987, Ch. 1138).

SPECIFIC FINDINGS

Existing federal law provides for a research tax credit equal to 20% of the amount by which a taxpayer's qualified research expenditures for a taxable year exceed its base amount for that year.

A 20% research tax credit also applies to the excess of (1) 100% of corporate cash expenditures (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the "university basic research credit."

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified

Board Position:

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<u> </u> SA	<u> </u> O	<u> </u> NAR
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Department Director

Date

Gerald Goldberg

1-29-99

research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers, including any firm that had both gross receipts and qualified research expenses in the first taxable year beginning after 1983 (so-called "start-up firms"), are assigned a fixed-base percentage of 3%.

In computing the credit, a taxpayer's base amount may not be less than 50% of its current-year qualified research expenditures. To prevent artificial increases in research expenditures by shifting expenditures among commonly-controlled or otherwise related entities, a special aggregation rule provides that all members of the same controlled group of corporations are treated as a single taxpayer. Special rules apply for computing the credit when a major portion of a business changes hands, under which qualified research expenditures and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage.

Taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise allowable) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65% applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1% (i.e., the base amount equals 1% of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5%. A credit rate of 2.2% applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5%, but do not exceed a base amount computed by using a fixed-base percentage of 2%. A credit rate of 2.75% applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2%. Taxpayers are permitted to elect the alternative incremental research credit regime for any taxable year beginning after June 30, 1996, and such election will apply to that taxable year and all subsequent taxable years unless revoked with the consent of the Secretary of the Treasury.

Qualified research expenditures eligible for the research tax credit consist of: (1) "in-house" expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; (3) 65% of amounts paid by the taxpayer for qualified research conducted on the taxpayer's behalf (so-called "contract research expenses"); and (4) 75% of amounts paid to a research consortium for qualified research if the research consortium is a tax-exempt organization and is organized and operated primarily to conduct scientific research, and the qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

To be eligible for the credit, the research must not only satisfy the existing research expenses deduction requirements, but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must pertain to functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors. In addition, research does not qualify for the credit if conducted after the beginning of commercial production of the business component, if related to the adaptation of an existing business component to a particular customer's requirements, if related to the duplication of an existing business component from a physical examination of the component itself or certain other information, or if related to certain efficiency surveys, market research or development, or routine quality control.

Expenditures attributable to research that is conducted outside the United States do not enter into the credit computation. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

Existing state law conforms with specific modifications to the federal research credit, as follows:

- For corporate taxpayers engaged in specified biopharmaceutical research and biotech research and development, the definition of "qualified organization" includes hospitals run by public universities and certain cancer centers.
- "Basic research" must be conducted in California to qualify for the California credit.
- Research that has a specific commercial objective may qualify as "basic research."
- The credit percentage is 11% for "qualified research" and 24% for corporations for "basic research." To duplicate the federal provision that allows the credit for "basic research" payments only to corporate taxpayers, the Bank and Corporation Tax Law (B&CTL) allows the credit based on "qualified research" expenses and "basic research" payments, while the Personal Income Tax Law (PITL) allows the credit only for "qualified research expenses."
- The formula for the state alternative incremental credit portion of the research expenses credit is 80% of the federal alternative incremental credit formula.
- California taxpayers may make the alternative incremental credit election at any one time, instead of having a window period for making the election that is comparable to the federal credit. Also, a taxpayer's federal election is not binding for state purposes.
- The state definition of "gross receipts" for purposes of the credit differs from that used in the federal credit.
- The termination dates provided under federal law do not apply to state law. The California research credit is allowed indefinitely for taxable and income years beginning on or after January 1, 1987.

This bill would increase the state credit for "qualified research expenses" from 11% to 15% and would decrease the minimum threshold for the taxpayer's base amount in computing the research expenses credit from not less than 50% to not less than 20% of the taxpayer's current year qualified research expenditures.

Implementation Considerations

Implementing this bill would occur during the department's normal annual system update.

Technical Considerations

This bill specifies that the changes it would make to the research expenses credit would apply to taxable or income years beginning on or after January 1, 1999; however, the bill does not specify that the existing provisions would stop applying on that date. Amendments 1 and 2 would include an ending date for the existing provisions.

Amendments 3 and 4 would clarify that no change would be made to the "basic research" portion of the credit that is allowed to corporations.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue impact of this bill is estimated to be revenue losses as shown below:

Revenue Impact of AB 68 Effective for income years Beginning on or After 1/1/99 Enacted after 6/30/99			
Losses in \$ Millions			
1998/99	1999/00	2000/01	2001/22
(\$0)	(\$30)	(\$50)	(\$50)

This estimate does not account for changes in employment, personal income, or gross state product that could result from this measure.

Revenue Estimate Discussion

The revenue impact of this proposal is estimated in the following manner. The research credits generated under current and proposed law are simulated for each corporation for the 1992 tax year based on a sample of 50 corporations with large research and development expenses. The simulation takes into account the taxpayers' income, historical research expenditures, and detailed tax and financial data. The results are weighted statistically to the population level. The revenue losses are estimated as the differences between the taxes under the current and proposed law. The revenue losses for 1992 are extrapolated to the 1999/00 and later fiscal

years using projected growth rates of business profit provided by the
Department of Finance.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 68
As Introduced December 7, 1998

AMENDMENT 1

On page 2, line 13, after "1997," insert:
and before January 1, 1999,

AMENDMENT 2

On page 4, line 29, after "1997," insert:
and before January 1, 1999,

AMENDMENT 3

On page 4, line 40, strikeout "both" and insert:
all

AMENDMENT 4

On page 5, line 4, after "(B)" insert:
The reference to "20 percent" in Section 41(a)(2) of the Internal Revenue Code is
modified to read "24 percent."
(C)